The Interest Rate Question

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The Marxists call it "impressionism": taking social or economic trends of the last few weeks or months and assuming that they will last forever. The problem is not realizing that there are underlying economic laws at work. Impressionism has always been rampant; and never more so than in public discussion of interest rates. For most of 1987, interest rates were inexorably high; for a short while after Black Monday, interest rates fell, and financial opinion turned around 180 degrees, and started talking as if interest rates were on a permanent downward trend.

No group is more prone to this day-to-day blowin' with the wind than the financial press. This syndrome comes from lack of understanding of economics and hence being reduced to reacting blindly to rapidly changing events. Sometimes this basic confusion is reflected within the same article. Thus, in the not-so-long ago days of double-digit inflation, the same article would predict that interest rates would fall because the Fed was buying securities in the open market, and *also* say that rates would be going *up* because the market would be expecting increased inflation. Nowadays, too, we read that fixed exchange rates are bad because interest rates will have to rise to keep foreign capital in the U.S., but also that *falling* exchange rates are bad because interest rates will have to rise for the same reason. If financial writers are mired in hopeless confusion, how can we expect the public to make any sense of what is going on?

In truth, interest rates, like any important price, are complex phenomena that are determined by several factors, each of which can change in varying, or even contradictory, ways.

As in the case of other prices, interest rates move inversely with the supply, but directly with the demand, for credit. If the Fed enters the open market to buy securities, it thereby increases the supply of credit, which will tend to lower interest rates; and since this same act will increase bank reserves by the same extent, the banks will now inflate money and credit out of thin air by a multiple of the initial jolt, nowadays about ten to one. So if the Fed buys one billion dollars of securities, bank reserves will rise by the same amount, and bank loans and the money supply will then increase by 10 billion dollars. The supply of credit has thereby increased further, and interest rates will fall some more.

But it would be folly to conclude, impressionistically, that interest rates are destined to fall indefinitely. In the first place, the supply and demand for credit are themselves determined by deeper economic forces, in particular the amount of their income that people in the economy wish to save and invest, as opposed to the amount they decide to consume. The more they save, the lower the interest rate; the more they consume, the higher. Increased bank loans may mimic an increase in genuine savings, yet they are very far from the same thing. Inflationary bank credit is artificial, created out of thin air; it does not reflect the underlying saving or consumption preferences of the public. Some earlier economists referred to this phenomenon as "forced" savings; more importantly, they are only temporary. As the increased money supply works its way through the system, prices and all values in money terms rise, and interest rates will then bounce back to something like their original level. Only a *repeated* injection of inflationary bank credit by the Fed will keep interest rates artificially low, and thereby keep the artificial and unsound economic boom going; and this is precisely the hallmark of the boom phase of the boom-bust business cycle.

But something else happens, too. As prices rise, and as people begin to anticipate further price increases, an inflation

premium is placed on interest rates. Creditors tack an inflation premium onto rates because they don't propose to continue being wiped out by a fall in the value of the dollar; and debtors will be willing to pay the premium because they too realize that they have been enjoying a windfall. And this is why, when the public comes to expect further inflation, Fed increases in reserves will *raise*, rather than lower, the rate of interest. And when the acceleration of inflationary credit finally stops, the higher interest rate puts a sharp end to the boom in the capital markets (stocks and bonds), and an inevitable recession liquidates the unsound investments of the inflationary boom.

An extra twist to the interest rate problem is the international aspect. As a long-run tendency, capital moves from low-return investment (whether profit rates or interest rates) toward high-return investments until rates of return are equal. This is true within every country and also throughout the world. Internationally, capital will tend to flow from low-interest to high-interest rate countries, raising interest rates in the former and lowering them in the latter.

In the days of the international gold standard, the process was simple. Nowadays, under fiat money, the process continues, but results in a series of alleged crises. When governments try to fix exchange rates (as they did from the Louvre agreement of February 1987 until Black Monday), then interest rates cannot fall in the United States without losing capital or savings to foreign countries.

In the current era of a huge balance of trade deficit in the U.S., the U.S. cannot maintain a fixed dollar if foreign capital flows outward; the pressure for the dollar to fall would then be enormous. Hence, after Black Monday, the Fed decided to allow the dollar to resume its market tendency to fall, so that the Fed could then inflate credit and lower interest rates.

But it should be clear that that interest rate fall could only be ephemeral and strictly temporary, and indeed interest

rates have already resumed their inexorable upward march. Price inflation is the consequence of the enormous monetary inflation pumped in by the Federal Reserve for several years before the spring of 1987, and interest rates are therefore bound to rise as well. Moreover, the Fed, as in many other matters, is caught in a trap of its own making; for the long-run trend to equalize interest rates throughout the world is a drive to equalize not simply money, or nominal, returns, but *real* returns corrected for inflation. But if foreign creditors and investors begin to receive dollars worth less and less in value, they will require higher money interest rates to compensate—and we will be back again, very shortly, with a redoubled reason for interest rates to rise.

In trying to explain the complexities of interest rates, inflation, money and banking, exchange rates and business cycles to my students, I leave them with this comforting thought: Don't blame *me* for all this, blame the government. Without the interference of government, the entire topic would be duck soup.

How the Market Creates Jobs and How the Government Destroys Them

Walter Block

The Creation of Jobs

If the media tell us that "the opening of XYZ mill has created 1,000 new jobs," we give a cheer. When the ABC company closes and 500 jobs are lost, we're sad. The politician who can provide a subsidy to save ABC is almost assured of widespread public support for his work in preserving jobs.